

Weekend Money

Saturday–Sunday, August 2-3, 2003

businessherald.co.nz

Diversify the golden rule

Everyone has heard the old warning about putting your eggs in one basket – but many investors aren't listening



Brent
SHEATHER

Of all the investment rules, diversification has to be one of the most important.

It is a basic principle of investing and extremely well known - entire forests have given up their lives to prove its importance. Even so, many investor's disasters can be traced, at least partly, to a lack of diversification.

Why, when everyone knows how important diversification is, do so many otherwise sensible investors ignore this basic rule? Given the extent to which diversification has become part of investment best practice, there must be some powerful forces pushing people in the other direction - towards concentrated, higher-risk portfolios.

PROBLEM 1: GREED

That's right, greed, avarice, usury. Concentrated investment portfolios often result from plain old greed, otherwise known as the pursuit of high returns.

And more often than not, investors have no one to blame but themselves.

A recent example is the sad case of the dreaded Metropolis bonds; buying these things - high risk, deeply subordinated loans on one building - was totally at odds with the diversification philosophy. Why lend money to one company, secured by one building, in one city, in one industry?

Answer: that 10 per cent yield looked so good compared to the bank.

The only sensible way to buy risky assets, be they junk bonds, shares or property, is as part of a portfolio of such assets.

Other investors fall head over heels in love with their investments.

The best local example is Brierley Investments. Rightly or wrongly - and the media take some blame here - Sir Ron came across as a swashbuckling, clever, pirate type who, having conquered the New Zealand and Australian corporate scene, was set to repeat the magic in London and New York. Sir Ron could do no wrong in the eyes of his devotees - typically men in the 40-60 age group.

Throughout the '70s and early '80s Brierley shares performed fabulously, reinforcing the wisdom of bigger and bigger weightings of BIL in share portfolios. For many New Zealand share investors, while BIL might have started off as 5 to

10 per cent of a portfolio, after price rises and the effect of the regular annual cash and bonus issues, by 1986 to 1987 weightings of 30, 40, 50 per cent and higher became common.

All well and good until ... the 1987 sharemarket crash. The rest of the story we know, the romance ended, rather nastily.

If you cannot or are unwilling to manage a share portfolio yourself, buy a managed fund.

If you must own specific shares, regularly rebalance the portfolio, keeping in mind the relative market capitalisation of the shares owned.

In the Brierley case, investors should have sold those cash issues, not taken them up. Easy to say, harder to do.

PROBLEM 2: NEW ISSUES

Stock Exchange boss Mark Weldon tells us that initial public offerings are the lifeblood of a stock exchange, but portfolio theory suggests that it is largely the institutions that should be buying new issues, not individuals.

Stockbrokers in New Zealand often see portfolios which have been constructed on the basis of each stock's likely gain on listing, rather than with any regard to diversity. To make matters worse, investors do not always follow the plan and take the immediate gains, but rather tend to believe the stories circulating at the time, let their "winners run" and retain an undiversified and risky portfolio.

Even the best performing new issues involve something of a trade-off - do you take the profit straight away and risk incurring capital gains tax on your entire portfolio, or do you hang in there with an undiversified and thus risky portfolio?

It is amazing that some advisers continually promote small, specialised shares to retail investors when portfolio theory, not to mention common sense, suggests they should go directly to managed funds.

PROBLEM 3: FASHION/PERFORMANCE

Fashion has a pervasive effect on financial markets, influencing large and small investors alike.

Combined with a year or so of stellar returns, the fashion/performance combination can be very hard to resist. The trick is to force yourself to acknowledge that when "everyone" is talking about the latest hot new thing, it has inevitably become overpriced.

The most recent example of investment fashion is the technology phenomenon. Before the technology fashion, we had "restructuring Europe", "emerging markets" and "Europe post-Glasnost" fashions.

Financial advisers are up against it here because by definition it is easiest to sell the latest investment fashion and what's more their corporate department has probably lined up some new float to capitalise on the mania. If they criticise it they may be seen as "not being a team player" and lose their jobs.

Investment fashions come and go and if you are lucky enough to forecast the next one you can gain extraordinary returns. But most of us are doomed to follow the leader and, as investors who piled into emerging markets in 1993 and still haven't got their money back now, it's a loser's game in the long run.

In contrast, by buying a balanced portfolio you guarantee your exposure to the next fashion, so that when someone ambles up to

you at some exclusive function you can honestly say: "Oh, I've owned Turkish bio-tech stocks for ages."

PROBLEM 4: FEES

Love of money is supposed to be the root of all evil, so it's no surprise that, in many instances, investment portfolio construction owes more to the higher fees on some products than to any sound commercial rationale.

One of the most obvious local examples is the syndicated property partnerships where "mum and dad" are advised to put their money into one (often provincial) building.

While the same adviser might recommend a globally diversified share portfolio they will also sell one property, in one sector, in one country, in one town. The contradiction is obvious, but the fact that these property instruments often produce fees two or three times the norm is a powerful attraction.

So powerful, in fact, that instead of the "normal" 5 to 10 per cent property component in their portfolios, some investors end up with a single property comprising 30 or 40 or 50 per cent of their assets. Again, diversification goes out the window.

The obvious solution might be to opt for a fee-based adviser who will charge the same fee no matter what initial charge is payable on a particular investment (they return any commissions to you) but this does not guarantee success.

Some advisers depend as much on the ongoing "trailing fees" which many investment products pay, so will prefer those funds that pay such fees.

PROBLEM 5: ADVISER BIAS

Advisers are only human so it's inevitable that some get stuck on

particular asset classes or types of investments.

Some like forests, some push high-yield stocks, a few flirt with Government bonds, many, like moths to a flame, gravitate to risky investments. (Personally, I know that I have a problem with listed property companies.)

It pays to know how your adviser invests his or her money, so ask. If you are 60 or 70 and your prospective adviser tells you he has lost half his money in a dot.com disaster but expects to get it all back and more via a South Korean bio-tech float, maybe he is the wrong fellow for you. It is critical that you understand what your adviser thinks the word "diversification" means.

How then do you know if you are properly diversified? The solution lies in considering the size of the specific bond/property/share relative to the universe of all bonds/properties/shares.

An example will illustrate: your financial adviser gives you a call praising the virtues of Promina. You don't have a clue whether it is good or bad. Your adviser has even less idea. So you look at its size relative to the NZ/Australian sharemarket - it will be less than 1 per cent of the combined NZ/Australian markets' capitalisation so if you have \$50,000 in NZ/Australian shares you should invest \$500 in Promina, ie forget about it.

This strategy is called "closet indexing" and attracts its fair share of critics but if you can't pick the best shares it is the way to go - most fund managers do it, they just won't admit it.

* Brent Sheather is a Whakatane investment adviser

